RESPONSE OF COMMISSION STAFF TO BENCH REQUESTS 3.1 AND 3.2

Bench Request 3.1: Please describe the expected or potential tax consequences associated with service provided under proposed Rate Schedule 449.

Bench Request 3.2: To the extent the tax consequences associated with service provided under proposed Rate Schedule 449 include the potential for reduced tax collections by any governmental entity, describe what arrangements could be made for payments in lieu of taxes.

RESPONSE

Due to the complexities raised by these Bench Requests, Staff deemed it advisable to provide a response in writing in advance of the hearings on March 21, 2001. Note that none of the following constitutes the opinion of any taxing jurisdiction, including the state of Washington.

I. Background

There are many federal, state, and local taxes related to electricity providers.

Property taxes related to utility operating property are assessed with respect to real or personal property used to generate, transmit or distribute electricity. Chapter 84.12 RCW. Persons liable for the tax are those owning, controlling, operating or managing that property.

Municipal corporations (*e.g.* cities and PUDs) are exempt from the property tax. PUDs are subject to a Privilege Tax, which is sometimes referred to as a tax in lieu of property tax. Chapter 54.28 RCW. The Privilege Tax is measured in part by gross sales revenues and in part by the wholesale value of some types of energy.

Sales and Use taxes generally are levied on retail sales and uses of tangible personal property. Chapters 82.08 and 82.12 RCW. Sales and use taxes do not apply to sales of electricity, but would apply to sales of equipment *etc.* related to construction of electrical facilities, for example. (Amendments are pending that, if enacted, could eliminate or reduce this tax effect).

Gross Receipts taxes are levied on the business activity of operating plant for generation, production, distribution, or wheeling of electricity for hire. The taxes are measured by the gross income from the business. Chapter 82.16 RCW (State Public Utility Tax); RCW 35.21.860-.870 (PUT levied by cities or towns).

If the revenues are those of an entity like a power marketer who does not operate electric plant, the state tax applicable to those gross receipts is the B&O tax. Chapter 82.04 RCW. A sale for resale deduction under the PUT makes that tax essentially a tax that applies at retail, though the deduction is only available to sales to others "in the same

business." *See* RCW 82.16.050(2). Therefore, revenues from a sale by a power producer to a power marketer, for example, would not be deductible to the power producer.

Federal Income taxes are levied on the net income of a business. Businesses are eligible for many deductions, such as depreciation, as well as investment tax credits. Special provisions can apply to utility businesses.

Miscellaneous taxes would include, for example, payroll taxes. Since the impact is not expected to be large, these taxes are not considered here.

II. Response to the Bench Requests

A. The Problem of Measuring Tax Effects of Schedule 449

The Bench Requests pose the general problem of evaluating the tax ramifications of Schedule 449, which enables former Schedule 48 and Special Contract customers to use an alternative supplier for their electrical energy. Self-generation, which can occur with or without Schedule 449, is also an alternative.

One problem is with what should one compare the potential tax consequences of Schedule 449? Should the comparison be to taxation under which many eligible customers have been self-generating? Should the comparison be to taxation under a $125 price cap applied to PSE? Should the comparison be to taxation pre-2000, before the Mid-C Index began to exceed historical levels? The tax consequences could be quite different.

A related problem is the inability to foresee exactly who will actually provide the power to customers under Schedule 449. There is no restriction on who may do so (other than providing that PSE will not be a supplier for other than Back-up service, and there is a requirement that sellers comply with state laws). Conceivable potential sellers could be municipal utilities, other investor-owned utilities regulated by the Commission presently, power marketers, and power providers located out of state delivering power to PSE at the Mid-Columbia or elsewhere. Again, numerous alternatives are available. Each may have different tax consequences. Given this situation, Staff's response is to offer a discussion of the types of potential tax impacts.

B. Commission Actions Have Tax Consequences[1]

There is no doubt Commission actions have tax consequences. Any approved increase or decrease in a utility's revenues will affect federal, state, and local tax revenues. For example, in Docket No. UT-950200, the Commission reduced the revenues of US WEST in the range of $100 million annually. This action had the approximate negative tax revenue impact of $42.38 million annually, or around $127 million for the three years those rates were in effect.[2] Other types of Commission action have tax consequences as well.[3]

C. RESPONSE TO BENCH REQUEST 3.1: The Potential Tax Consequences of Schedule 449

Bench Request 3.1: Please describe the expected or potential tax consequences associated with service provided under proposed Rate Schedule 449.

This question is difficult to answer. It is perhaps best to respond using an analysis of various scenarios. The following assumes the seller complies with all applicable laws.

Scenario 1: The Seller is a PUD located in Washington.

Potential Tax Consequences: State PUT would be remitted on the revenues received by the PUD from the Schedule 449 Customer. Local PUT would be remitted on the revenues received by the PUD if the PUD conducted an activity taxable under the PUT in any local taxing jurisdiction.[4] State and local PUT would be remitted by PSE on the revenues from the wheeling services PSE rendered.

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[1] A legal issue is presented by these Bench Requests 3.1 and 3.2, *i.e.* whether consequences to the tax revenues received by federal, state, or local taxing jurisdictions are impacts for consideration under the public service laws. There was insufficient time for Staff to fully evaluate this legal issue. At the margin, however, if the Stipulation of Settlement is found to satisfy all statutory requirements without consideration of possible tax effects, the Commission should, nonetheless, approve the Stipulation of Settlement. If potential tax consequences are a concern, the Commission could alert the proper taxing authorities so they could plan for the potential tax consequences of the Commission's decision. Such authorities and the legislature may have options for capturing lost tax revenues, if any, should they deem that appropriate. *See* Staff Response to Bench Request 3.2, *infra*.

[2] $6.4 million is $6 million in state retail sales tax (tax rate of 6% times $100 million) plus $470,000 million in state retailing B&O tax (tax rate of .0047 times $100 million). $1.58 million is $1.5 million in local retail sales tax (tax rate of 1.5% times $100 million – cap on local rate was later changed to 2%) plus $80,000 in local B&O tax (based on using the excess of the conversion factor for local taxes in Docket No. UT-950200 of around .005492 and deducting the .0047 state B&O tax rate of .0047 = approx. .0008, times $100 million = $80,000). $34.4 million is tax rate found in an approximate average of conversion factors for FIT in Docket No. UT-950200 times $100 million.

[3] Any approved conservation programs, for example, will affect taxable revenues (assuming rates stay constant), as well as retail sales and use taxes, to the extent energy measures are actually purchased and installed. Certain tax exemptions under the PUT were once available for such measures as well. RCW 82.16.055.

[4] Under *City of Seattle v. Paschen Contractors, Inc.*, 111 Wn.2d 54 (1988), it is not necessarily unlawful for two local jurisdictions to tax the same type of activity of a taxpayer, so long as the activity occurs in both jurisdictions.

To the extent PSE is able to make sales with the resources it would otherwise use to serve the load of the Schedule 449 customer, state and local PUT would be remitted by PSE on those revenues.[5]

To the extent the PUD purchased natural gas to produce the power sold, where PSE did not, additional state PUT would be remitted by the seller of the natural gas. *See* RCW 82.16.010(5) (taxation of gas distribution business). Local PUT would also increase if the seller of the natural gas operated plant in a local PUT taxing jurisdiction.

If the total PUT-taxable revenues in this scenario are greater than what PSE would have received but for Schedule 449, the state and local PUT tax revenues will be increased accordingly. If the total PUT-taxable revenues in this scenario are less than what PSE would have received but for Schedule 449, the state and local PUT tax revenues will be reduced accordingly. To the extent the PUD does not conduct a taxable activity in the local jurisdiction in which PSE delivered power prior to Schedule 449, the local PUT revenues for that taxing jurisdiction would decrease.

State and local sales and use tax revenues would increase to the extent the PUD purchased or used taxable materials, equipment, *etc*. to build plant to serve the incremental load. (Amendments are pending that, if enacted, could eliminate or reduce this tax effect).

State Privilege Tax revenues would increase.

Property taxes on PSE would likely not change by this scenario, since its property would be used to serve other customers. PUDs are not subject to state property taxes.

Federal income tax revenues would change in an amount of approximately 35% times the incremental change in taxable net income, if any, to PSE. PUDs are not subject to FIT.

Scenario 2: The Seller is a private company power supplier located in Washington.

Potential Tax Consequences: State PUT would be remitted on the revenues received by the private company power supplier (hereafter "Company") from the Schedule 449 Customer. Local PUT would be remitted on the revenues received by the Company if the Company conducted a taxable activity under the PUT in a local taxing jurisdiction.[6] State and local PUT would be remitted by PSE on the revenues from the wheeling services PSE renders.

[5]An exception would apply to the extent PSE sells that electricity for consumption outside the state. In that situation, those revenues are likely eligible for deduction from revenues subject to PUT. RCW 82.16.050(9). This would reduce PUT receipts.

[6]*See* footnote 4, *supra*.

To the extent PSE is able to make sales with the resources it would otherwise use to serve the load of the Schedule 449 customer, state and local PUT would be remitted by PSE on those revenues.[7]

To the extent the Company purchased natural gas to produce the power sold, where PSE did not, additional state PUT would be remitted by the seller of the natural gas. *See* RCW 82.16.010(5) (taxation of gas distribution business). Local PUT would also increase if the seller of the natural gas operated plant in a local PUT taxing jurisdiction.

If the total PUT-taxable revenues in this scenario are greater than what PSE would have received but for Schedule 449, the state and local PUT tax revenues will be increased accordingly.

If the total PUT-taxable revenues in this scenario are less than what PSE would have received but for Schedule 449, the state and local PUT tax revenues will be reduced accordingly. To the extent the Company does not conduct a taxable activity in the local jurisdiction in which PSE delivered power prior to Schedule 449, the local PUT revenues for that taxing jurisdiction would decrease.

State and local sales and use tax revenues would increase to the extent the Company purchased taxable materials, equipment, *etc.* to build plant to serve the incremental load. (Amendments are pending that, if enacted, could eliminate or reduce this tax effect).

Property taxes on the Company would increase to the extent it added taxable property to serve the Schedule 449 customer's load. Property taxes on PSE would likely not change by this scenario, since its property would be used to serve other customers.

Federal income tax revenues would change in an amount of approximately 35% times the incremental reduction change in taxable net income, if any, to PSE. Federal income taxes would change in an amount of approximately 35% times the incremental change in taxable net income of the Company.

Scenario 3: The Seller is a private company power supplier located outside Washington. Power is wheeled to a PSE delivery point in Washington by a third party.

Potential Tax Consequences: Whether state or local PUT would be remitted on the revenues received by the Out of State Seller power supplier from the Schedule 449 Customer depends on how the tax statutes are interpreted. RCW 82.16.020 levies the PUT on the privilege of engaging in business "within this state." This could mean the taxpayer must "operate electric plant" in this state, or this could mean the tax payer need

[7] *See* footnote 5, *supra*.

only operate plant "for hire" within this state. If the latter, the out of state seller could be required to remit PUT, if it had tax nexus. *See* discussion in footnote 10, *infra*.

State and local PUT would be remitted by PSE on the revenues from the wheeling services PSE renders. State and local PUT would be remitted by the third party wheeling service provider, presumably apportioned to the intrastate Washington level to avoid federal Commerce Clause issues.[8]

To the extent PSE is able to make sales with the resources it would otherwise use to serve the load of the Schedule 449 customer, state and local PUT would be remitted by PSE on those revenues.[9]

If the total PUT-taxable revenues in this scenario are greater than what PSE would have received but for Schedule 449, the state and local PUT tax revenues will be increased accordingly. If the total PUT-taxable revenues in this scenario are less than what PSE would have received but for Schedule 449, the state and local PUT tax revenues will be reduced accordingly.

There would be no Washington state property taxes on the out of state property of the Out of State Seller. Property taxes on PSE would likely not change by this scenario, since its property would be used to serve other customers.

Federal income tax revenues would change in an amount of approximately 35% times the incremental change in taxable net income, if any, to PSE. Federal income taxes would change in an amount of approximately 35% times the incremental change in taxable net income of the Out of State Seller.

If the Out of State Seller was not subject to state or local taxes in this state, it might be subject to state and local taxes of another state. If so, those tax revenues of the other state or local taxing jurisdictions would increase compared to the *status quo ante*, if they were measured by gross income. If they were measured by net income, the resulting tax revenue change depends on the change in net income due to the sale.

Scenario 4: The Seller is a power marketer.

Potential Tax Consequences: State PUT would not be remitted on the revenues received by the power marketer from the Schedule 449 Customer. A pure marketer, by definition, does not operate plant, and therefore does not engage in a taxable activity under the PUT.

State and local PUT would be remitted by the entity selling the power to the power marketer, to the extent that entity engaged in an activity in this state that is taxable

[8] *See* RCW 82.16.050(6) and, generally, *Complete Auto Transit Co. v. Brady*, 430 U.S. 274 (1977).
[9] *See* footnote 5, *supra*.

under the PUT. That entity would not receive the sale for resale deduction since power marketers are not in the same public service business. *See* RCW 82.16.050(2).

The power marketer would pay state B&O tax on its revenues from the sales it makes, so long as it has tax nexus with this state.[10]

State and local PUT would be remitted by PSE on the revenues from the wheeling services PSE rendered.

To the extent PSE is able to make sales with the resources it would otherwise use to serve the load of the Schedule 449 customer, state and local PUT would be remitted by PSE on those revenues.[11]

If the total PUT-taxable revenues in this scenario are greater than what PSE would have received but for Schedule 449, the state and local PUT tax revenues will be increased accordingly. If the total PUT-taxable revenues in this scenario are less than what PSE would have received but for Schedule 449, the state and local PUT tax revenues will be reduced accordingly.

Property taxes on the power marketer would likely not increase. Property taxes on the entity selling power to the power marketer would increase to the extent it added taxable property to serve the Schedule 449 customer's load, and that property was located in this state. Property taxes on PSE would likely not change by this scenario, since its property would be used to serve other customers.

Federal income tax revenues would change in an amount of approximately 35% times the incremental change in taxable net income, if any, to PSE. Federal income taxes would change in an amount of approximately 35% times the incremental change in taxable net income of the power marketer, as well as the entity selling power to the power marketer.

C. RESPONSE TO BENCH REQUEST 3.2: Whether payments could be made to taxing jurisdictions in lieu of taxes

Bench Request 3.2: To the extent the tax consequences associated with service provided under proposed Rate Schedule 449 include the potential for reduced tax

[10]Tax nexus is a federal constitutional requirement. For retail sales tax purposes, tax nexus requires some form of physical presence in the state. *E.g. Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). Nexus requirements for B&O tax or PUT purposes is not so clear. The holding in *Quill* was expressly limited to sales tax cases, and the Court cautioned that "we have not adopted a similar bright line physical presence requirement" for "other types of taxes." 504 U.S. at 314. A leading commenter in the tax area has noted a lower nexus standard should apply to taxes such as the PUT or B&O tax. *See* Hellerstein, *State Taxation*, § 6.08 (1992): "Any corporation that regularly exploits the markets of a state should be subject to its jurisdiction to impose an income or franchise tax." Suffice it to say, the minimum tax nexus threshold for B&O and PUT purposes will not be resolved in this case. Hopefully, over time, it will be resolved so that more certainty can apply in this area of law.

[11]*See* footnote 5, *supra*.

collections by any governmental entity, describe what arrangements could be made for payments in lieu of taxes.

If what is described in this request are voluntary payments of a tax liability that no longer exists in fact or law, then there probably is no arrangement that should or would be made. From the perspective of setting rates that are fair, just, reasonable, and sufficient, such a voluntary payment (to the IRS, for example) would almost certainly be rejected by Staff as an improper expense to recover through rates.[12]

Options are available to some local taxing authorities. RCW 35.21.870 permits a local PUT to be increased in excess of 6% upon voter approval. At least some, if not all, lost revenue could be recovered through that self-help mechanism.

The other alternative is legislative change. Many, if not all, of the potential revenue loss consequences are directly related to the fact that the PUT (state and local) is not a tax on consumption, but rather on the business activities of light and power businesses. If the tax was on consumption of electricity in this state, many of the issues described herein would be resolved (*e.g.* taxation of remote sellers). But that is a question of legislative policy that will need to be resolved by the legislature. Perhaps approval of the Stipulation of Settlement in this docket will be what is needed to spur reform in this area.

[12]If this bench request refers to the subject of WUTC regulatory fees (which are not taxes), PSE's resources previously used to serve Schedule 449 customers would presumably be available for market or core sales transactions. It is difficult to measure the impact, if any, on WUTC regulatory fees of Schedule 449 due to these off-setting revenue sources.